SECURITIES AND EXCHANGE COMMISSION

17 CFR Parts 275 and 279

[Release No. 34–35375; IA–1469; S7–5–95]

RIN 3235–AG36

Disclosure by Investment Advisers Regarding Soft Dollar Practices

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rule and form.

SUMMARY: The Commission is proposing for comment a new rule and form under the Investment Advisers Act of 1940 that would require certain investment advisers to provide clients with an annual report regarding their use of client brokerage. The proposed report would include disclosure about an adviser's use of its clients' brokerage commissions during the previous year, including information about research and other services obtained by the adviser with those commissions. The proposed annual report is intended to provide investment advisory clients with important information about the brokerage commissions they pay and their advisers' receipt of ''soft dollar'' benefits from those commissions.

DATES: Comments should be received on or before May 19, 1995.

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549. All comment letters should refer to File No. S7–5–95. All comments received will be available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.

FOR FURTHER INFORMATION CONTACT: Eric C. Freed, Special Counsel, or Robert E. Plaze, Assistant Director, (202) 942–0721, Office of Disclosure and Investment Adviser Regulation, Division of Investment Management, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: The Securities and Exchange Commission today is proposing for comment:

(1) rule 204–4 (17 CFR 275.204–4) under the Investment Advisers Act of 1940 (15 U.S.C. 80b–1 *et seq.*) (''Advisers Act''), which would require an investment adviser registered or required to be registered under the Advisers Act to deliver to its clients an annual report on the adviser's direction of client brokerage transactions and its receipt of research and other services in connection with those transactions; and

(2) Form ADV–B under the Advisers Act, which would set forth the information required to be included in the annual report.

Executive Summary

The Commission is proposing a new rule and form under the Advisers Act to require each investment adviser (''adviser''), registered or required to be registered under the Advisers Act, that has the discretion to direct client brokerage transactions and receives services other than execution in exchange for that brokerage, to provide its clients with a report that would contain information about its use of client brokerage. The report would disclose for the adviser's most recently completed fiscal year, (1) the twenty brokers to which the adviser directed the largest amounts of commissions and certain other transaction-related payments (collectively, ''commissions''), (2) the three brokers substantially all of whose services for the adviser were execution services (''execution-only brokers'') to which the adviser directed the largest amounts of commissions, (3) the aggregate amount of commissions directed by the adviser to each broker listed and the percentage of the adviser's total discretionary brokerage this amount represents, (4) the average commission rate paid to each broker listed, and (5) for each broker other than an execution-only broker, information concerning products or services obtained from the broker. The report would also disclose the percentages of the adviser's total commissions that are directed to execution-only brokers, to other brokers, and at the request of clients. The report would require only information about an adviser's use of client brokerage on an aggregate basis; it would not require separate information about the brokerage of the adviser's various clients. The report would be provided to existing advisory clients annually and to prospective advisory clients no later than the time that an advisory agreement is entered into.

I. Background

Soft dollar practices are arrangements under which products or services other than execution of securities transactions (''soft dollar services'') are obtained by an adviser from or through a broker in exchange for the direction by the adviser of client brokerage transactions to the broker.[1] Soft dollar practices are common in the institutional brokerage market. According to an informal annual survey of investment advisers and other institutions, nearly ninety percent of these institutions engage in soft dollar arrangements, and more than forty percent of commissions are directed primarily for the purpose of obtaining research services.[2]

Soft dollar practices originally developed as a means by which brokers provided discounts on brokerage commissions that were fixed pursuant to exchange and commission rules. In 1975, the Commission prohibited fixed commission rates[3] and, later that year, Congress codified the Commission's action.[4] After the Commission abolished fixed rates, concerns were raised whether the soft dollar practices that had developed in the context of fixed rates would continue to be consistent with various state and federal laws, including the Advisers Act.[5]

Underlying these concerns is an adviser's fundamental obligation under the Advisers Act (and state law) to act in the best interest of its clients.[6] This duty requires the adviser to obtain best execution of client transactions,[7] and precludes the adviser from using client assets for its own benefit or the benefit of other clients, at least without client consent.[8] Upon the Commission's eliminating fixed commission rates, some argued that an adviser could be deemed to have violated this duty if the adviser caused a client's account to pay anything but the lowest commission rates. If this view was upheld, soft dollar arrangements could have been effectively precluded by the decision to eliminate fixed commission rates.

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[1] See Securities Exchange Act Rel. No. 23170 (Apr. 23, 1986) [51 FR 16004 (Apr. 30, 1986)] (''Release 23170'') at § I; Robert J. Moran & Cathy G. O'Kelly, Soft Dollars and Other Traps for the Investment Adviser, 1 DePaul Bus. L.J. 45, 45 n.5 (1989).

[2] Greenwich Associates, Soft-Dollars: Opportunities and Challenges (special presentation of May 10, 1994); Greenwich Associates, Institutional Equity Investors 1994 (statistical supp.) 3, 17.

[3] Securities Exchange Act Rel. No. 11203 (Jan. 23, 1975) (40 FR 7394 (Feb. 20, 1975)).

[4] Securities Acts Amendments of 1975, Pub. L. No. 94–29, 89 Stat. 97, 107–08 (enacting Section 6(e)(1) of the 1934 Act (15 U.S.C. 78f(e)(1))).

[5] S. Rep. No. 75, 94th Cong., 1st Sess. 70 (1975).

[6] *See SEC* v. *Capital Gains Research Bureau, Inc.*, 375 U.S. 180, 194 (1963).

[7] *Delaware Management Co.*, 43 S.E.C. 392, 396 (1967). An adviser is obligated to use reasonable diligence to select a broker who will ''execute securities transactions for clients in such a manner that the client's total cost or proceeds in each transaction is most favorable under the circumstances.'' Securities Exchange Act Rel. No. 23170 (Apr. 23, 1986) [51 FR 16004 (Apr. 30, 1994)] (''Release 23170'') at § V (citing *Kidder, Peabody & Co.*, 43 S.E.C. 911, 915 (1968)). An adviser should consider the full range and quality of the broker's services, including the value of research received, in assessing whether a broker will provide best execution. *Id.*

[8] Restatement (Second) of Trusts § 170 comment a, § 216 (1959).

Congress, in codifying the abolition of fixed commission rates, responded to these concerns by enacting Section 28(e) of the Securities Exchange Act of 1934 (the ''1934 Act'') [15 U.S.C. 78bb(e)], which provides a safe harbor for certain soft dollar arrangements.[9] Section 28(e) provides, in pertinent part, that an adviser with investment discretion over an account will not be deemed to have acted unlawfully or to have breached its fiduciary duty by causing the account to pay a higher commission to a broker that provides research benefiting the adviser's accounts. To rely on the Section 28(e) safe harbor, an adviser must determine in good faith that the commissions paid are reasonable in relation to the value of the brokerage and research services provided, either in terms of the particular transaction or the adviser's overall responsibilities towards its discretionary accounts.[10]

Section 28(e) modifies a fiduciary's strict duty to act in the best interest of each client with respect to the management of each client's assets. Thus, it permits an adviser to cause a client to pay higher commissions than otherwise are available to obtain research that may not be used exclusively for the benefit of the client or used to benefit the client at all. Section 28(e), however, does not afford a safe harbor with respect to all conflicts of interest between the adviser and its clients that may arise from soft dollar arrangements. For example, soft dollar arrangements may cause an adviser, in order to obtain soft dollar services, to violate its best execution obligations by directing client transactions to brokers who could not adequately execute the transactions. Soft dollar arrangements also may give advisers incentives to trade client securities inappropriately to generate credits for soft dollar services.[11]

Soft dollar practices also diminish the ability of a client to evaluate the expenses it incurs in obtaining portfolio management services and may hinder the ability of the client to negotiate fee agreements, because the costs of soft dollar services are ''hidden'' from investors in brokerage commissions. By permitting advisers to use their clients' transactions to pay for research services that they otherwise would have to purchase with ''hard dollars,'' soft dollar arrangements permit advisers to charge fees that do not fully reflect the cost of portfolio management. Advisers that do not engage in soft dollar arrangements may be put at a competitive disadvantage if they pay for services with hard dollars and attempt to pass the cost of these services on to clients through higher fees.

Congress recognized the conflicts that soft dollar practices present and provided in section 28(e) authority for the Commission to require advisers to disclose to their clients their policies and practices with respect to the use of client commissions.[12] The Commission has never adopted rules under section 28(e),[13] but has instead required certain disclosure in Part II of Form ADV, which specifies the content of the disclosure document or ''brochure'' that an adviser is required to provide to clients before entering into advisory relationships.[14] If soft dollar arrangements are a factor in selecting brokers to effect client transactions, the brochure must disclose the nature of the adviser's soft dollar practices, including: (i) the services that the adviser obtains through soft dollar arrangements; (ii) whether clients may pay higher commissions (''pay up'') as a result of the arrangements; (iii) whether soft dollar services are used to benefit all client accounts or only those accounts the brokerage of which was used to purchase the services; and (iv) any procedures that the adviser uses to allocate brokerage.[15]

Two broker-dealers, Goldman, Sachs & Co. and Morgan Stanley Group Inc., themselves providers of research services to advisers, have strongly criticized the effectiveness of current disclosure requirements.[16] Current disclosure primarily focuses on the policies and practices that the adviser intends to follow with respect to the use of client brokerage.[17] This disclosure does not, Goldman, Sachs and Morgan Stanley assert, adequately disclose to clients the extent to which an adviser has soft dollar commitments or the specific benefits that accrue to the adviser from the use of the client brokerage. These brokers have proposed that the Commission adopt a requirement that advisers periodically report to clients the soft dollar benefits that they have received and the specific value of those benefits, as well as certain information about how the brokerage of each client was directed (the ''Goldman/Morgan Proposal'').[18] Other participants in soft dollar arrangements, organized by the Alliance in Support of Independent Research, have argued that current client disclosure by advisers is adequate and that the Goldman/Morgan Proposal is anticompetitive and discriminatory.[19]

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[9] Securities Acts Amendments of 1975, Pub. L. No. 94–29, 89 Stat. 97, 161–62.

[10] The Commission has stated that a product or service may legitimately be considered a ''brokerage or research service'' covered by the safe harbor if it provides ''lawful and appropriate assistance to the [adviser's] decision-making process.'' Release 23170, *supra* note 1. The Commission's Division of Market Regulation has addressed the types of transactions that are afforded the protection of the safe harbor. *See* U.S. Department of Labor (pub. avail. July 25, 1990) (safe harbor does not extend to principal, riskless principal and futures transactions); Hoenig & Co. (pub. avail. Oct. 15, 1990) (same); Instinet Corporation (pub. avail. Jan. 15, 1992) (safe harbor does apply to agency transactions in equity securities on a computer-based real time market information and brokerage system and after-hours order matching system).

[11] See *Securities and Exchange Commission* v. *Galleon Capital Management,* Litigation Rel. No. 14315 (Nov. 1, 1994). The Commission's complaint in *Galleon,* in addition to alleging excessive trading in order to generate soft dollar credits, alleged that the adviser requested brokers to make soft dollar payments to a consulting firm, and that these payments eventually were rebated to the adviser. See also Letter from Bradford P. Schaaf, Chairman, and Victor J. Fontana, President and Chief Executive Officer, Autranet, Inc. to Barry P. Barbash, Director, Division of Investment Management and Brandon Becker, Director, Division of Market Regulation (Nov. 10, 1994) (''Autranet Letter'') (proposing that the Commission prohibit a broker from requiring an adviser, by contract or understanding, to commit to direct any specified amount of commissions to the broker in order to receive soft dollar services).

[12] Section 28(e)(2) (15 U.S.C. 78bb(e)(2)).

[13] In 1976, the Commission proposed rule 28e2–1 under the 1934 Act, but the rule was never adopted. See note 41 infra.

[14] Rule 204–3 under the Advisers Act (17 CFR 275.204–3) requires that a registered investment adviser deliver the brochure to a prospective client before entering into an advisory contract with the client, and, annually thereafter, provide or offer to provide the client with the brochure. The Commission is not at this time proposing to amend the Form ADV requirements regarding disclosure of soft dollar arrangements. The Commission, however, is considering whether changes to these requirements would be appropriate, and may propose changes in connection with future revisions to Form ADV.

[15] Item 12 of Part II of Form ADV. Registered investment companies are required to include similar disclosure in their Statements of Additional Information. See, e.g., Item 17 of Form N–1A (17 CFR 239.15A, 274.11A).

[16] See Future of the Stock Market: Soft Dollars, Hearing Before the Subcomm. on Telecommunications and Finance of the House Comm. on Energy and Commerce, 103d Cong., 1st Sess. (1993) (''1993 Hearings'') (testimony of David M. Silfen, Partner, Goldman, Sachs & Co. and Anson M. Beard, Jr., Managing Director, Morgan Stanley Group Inc.).

[17] The Commission has instituted a number of enforcement actions against advisers based, at least in part, on the failure to disclose soft dollar arrangements adequately. See, e.g., Securities and Exchange Commission v. Galleon Capital Management, supra note 11; Kingsley, Jennison, McNulty & Morse, Inc., Investment Advisers Act Rel. No. 1396 (Dec. 23, 1993); DeMarche Associates, Investment Advisers Act Rel. No. 1392 (Nov. 23, 1993); Jack Allen Pirrie, Investment Advisers Act Rel. No. 1284 (July 29, 1991); Robert Michael Lee, Investment Advisers Act Rel. No. 1249 (Sept. 17, 1990); Patterson Capital Corp., Investment Advisers Act Rel. No. 1235 (June 25, 1990).

[18] The Goldman/Morgan Proposal will be placed in the public comment file for the Commission's proposal.

[19] *See* Letter from The Alliance in Support of Independent Research to Jonathan G. Katz,

Continued

The difference in the views of these two groups may reflect the differences in the ways the two groups provide research services to advisers and the effect that the Goldman/Morgan Proposal would have on each group. Goldman, Sachs and Morgan Stanley operate as ''full service brokers'' and provide a variety of execution, research and related services to clients. An adviser who executes client securities transactions through these firms typically receives research services developed by the firms (''proprietary'' soft dollar services), much of which is provided without being directly requested by the adviser. The cost of such services generally are bundled in the overall commission charged by the full service broker. In contrast, a ''soft dollar broker'' typically provides advisers with services prepared or produced by parties other than the broker (''third-party'' soft dollar services) in exchange for the allocation of specified amounts of commission dollars.[20] In these types of arrangements, an explicit price denominated in commission dollars, rather than in hard dollars, is typically attached to the research.[21]

The Goldman/Morgan Proposal would affect the two groups of brokers differently. Because proprietary soft dollar services are not offered for a specific price in commission dollars, under the Goldman/Morgan Proposal, disclosure would be required only about the price and value of third-party soft dollar services. Soft dollar brokers argue that if the Commission required more extensive disclosure of third-party soft dollar services than proprietary soft dollar services, advisory clients might be led to believe that advisers derive benefits from soft dollar brokers at the clients' expense that they do not derive from full service brokers, when, in fact, both types of firms confer benefits on advisers.[22] As a result, advisers might be discouraged from using soft dollar brokers.

Representatives of some investment advisers have asserted that current disclosure requirements are adequate.[23] According to these advisers, clients rarely request information about the soft dollar benefits that the adviser receives, and those that are interested currently may obtain the information on request.[24] Other investment advisers, however, argue that the nature of the conflicts involved in soft dollar arrangements warrant more extensive client disclosure than is currently required.[25]

The Commission staff considered issues related to soft dollars in its ''Market 2000'' report on the equity markets released in January 1994.[26] In that report, the staff recommended that quantifiable information about soft dollar services be required to be provided to advisory clients.[27] The report also stated that ''[m]ost importantly * * * any new disclosure requirements should apply equitably. Thus, research and other services obtained either from (full service) firms or (soft dollar) firms should be subject to disclosure.''

II. Discussion

The Commission believes that, in light of the conflicts of interest presented by soft dollar arrangements, additional disclosure about these practices may be warranted. While current disclosure may provide sufficient notice to a client that the adviser has these conflicts, it may not provide the client with sufficient information to permit it to assess the extent to which the adviser obtains soft dollar services or pays up for those services, or the types of services that the adviser obtains through soft dollar arrangements. Enhanced disclosure may provide existing clients with information useful in negotiating limits on the use of their brokerage, and enable prospective clients to make better informed choices of advisers.

The Commission is therefore proposing that certain registered advisers be required to provide clients with annual reports setting forth certain information about their use of client brokerage and the soft dollar services each adviser received during its most recently completed fiscal year.[28] The proposal is intended to provide an advisory client with information that can be used to evaluate the extent to which the client benefits from the adviser's brokerage practices, the extent to which the adviser benefits, and whether the client should attempt to limit the adviser's use of its brokerage. Consistent with the recommendations of the staff in the Market 2000 report, the proposed disclosure requirements would not impose different

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Secretary, Securities and Exchange Commission (Oct. 17, 1994), Commission File No. S7–22–94 (''Alliance Letter''); see also Autranet Letter, *supra* note 11. The Alliance in Support of Independent Research is ''a group of broker-dealers, money managers and research firms sharing a common interest in fostering a favorable regulatory environment in which independent research services and products may be furnished to the money management community.''

[20] In 1980, the Commission stated that research provided through third-party arrangements falls within Section 28(e) of the Exchange Act, even if the money manager participates in selecting the research services provided to it and the research is delivered directly to the money manager by the third party. Securities Exchange Act Rel. No. 17371 (Dec. 12, 1980) (45 FR 83707 (Dec. 19, 1980)). The Section 28(e) safe harbor is not available to third-party soft dollar arrangements unless, among other things, the broker is obligated to the third party to pay for the services. Release 23170, *supra* note 1, at § III; *Kingsley, Jennison, McNulty & Morse, Inc.*, *supra* note 17.

[21] Some full service brokers also will enter into third-party soft dollar arrangements with advisers.

[22] See Alliance Letter, *supra* note 19.

[23] See, e.g., 1993 Hearings, *supra* note 16 (statement of Holly A. Stark, Senior Vice President, Dalton, Greiner, Hartman, Maher & Co.).

[24] Many pension plans require some form of soft dollar reporting from their money managers, primarily in response to a pronouncement of the Department of Labor, the principal federal regulator of employee benefit plans under the Employee Retirement Income Security Act of 1974 (''ERISA''), concerning the ongoing duty of plan fiduciaries to monitor the use of soft dollars by managers. See ERISA Technical Release No. 86–1.

Section 15(c) of the Investment Company Act of 1940 (15 U.S.C. 80a–15(c)) requires the directors of a registered investment company to request and review, and the company's adviser to supply, such information as may reasonably be necessary to evaluate the terms of the advisory contract between the adviser and the investment company. As discussed above, soft dollar arrangements may bear upon the reasonableness of advisory fees. *See* text accompanying note 12 *supra.* Investment company advisers that engage in soft dollar arrangements therefore must provide their boards of directors with information regarding soft dollar arrangements. See Release 23170, *supra* note 1, at § IV.B.3.

Various institutional investors have expressed their views on soft dollar arrangements. *See* 1993 Hearings (statement of Fred G. Weiss, Chairman, Financial Executive Institute's Committee on Investment of Employee Benefit Assets (''CIEBA'')). Mr. Weiss stated that CIEBA, which represents 150 corporate benefit plan sponsors with assets of approximately $600 billion, was unable to develop a clear consensus on whether soft dollar practices were desirable or not. CIEBA did, however, call for more comprehensive reporting of soft dollar arrangements at a firm-wide level to supplement the client-specific information that most of its members currently receive. Other institutional investors believe that current disclosure is adequate. *See* 1993 Hearings (written statement of State Board of Administration of Florida). In addition, the Institutional Investors Committee of the National Association of Securities Dealers, Inc. (''NASD Committee''), which includes representatives of institutional investors, advisers, and brokerage firms, submitted a recommendation to the Commission's staff for additional soft dollar disclosure. The NASD Committee's recommendation was approved by the NASD's Board of Governors. The NASD Committee's recommendation will be placed in the public comment file for the Commission's proposal.

[25] *See* Letter from Louis R. Cohen and Marianne K. Smythe, Wilmer, Cutler & Pickering to Jonathan G. Katz, Secretary, Securities and Exchange Commission (Oct. 17, 1994) (on behalf of Investors Research Corp.) (''Investors Research Letter''), Commission File No. S7–22–94.

[26] *See* U.S. Securities and Exchange Commission, Division of Market Regulation, Market 2000: An Examination of Current Equity Market Developments (Jan. 1994).

[27] *Id.* at V–15.

[28] The proposed amendments would not require that advisers provide each client with information about how that client's transactions were directed. See Section II.F infra.

requirements on third-party and proprietary soft dollar arrangements.

A. The Annual Report in General

The Commission is proposing a new rule under the Advisers Act, rule 204–4, that would require any adviser, registered or required to be registered under the Advisers Act, that has brokerage discretion [29] over any client account and that receives soft dollar services to deliver an annual report to clients on its use of client brokerage. The contents of the annual report would be specified in new Form ADV–B.

The core of the annual report would be a table disclosing information regarding the adviser's direction of client brokerage. The table would list the twenty brokers other than execution-only brokers (''research brokers'') to which the adviser directed the greatest amount of client commissions,[30] and the three execution-only brokers to which the adviser directed the greatest amount of client commissions during its most recent fiscal year.[31] For each broker listed, the table would disclose: the aggregate amount of commissions directed by the adviser to the broker; the percentage of the adviser's discretionary brokerage commissions that this represents; the average commission rate (in cents per share) paid to the broker; and a description of the soft dollar services provided by the broker.[32]

The table would provide an overview of the brokers used by an adviser to execute client transactions, the commissions charged by the brokers, and the soft dollar services received from research brokers. This disclosure is intended to assist an advisory client in evaluating the adviser's use of its brokerage, including whether the client could be paying lower commissions, whether the adviser is obtaining soft dollar services that can be used to benefit the client, and whether the advisory fee charged to the client is appropriate in light of the services that the adviser pays for with client commissions. Institutional clients using the services of more than one adviser and prospective clients considering different advisers will be able to use the table to compare advisers' use of brokerage, including the commission rates that they negotiate and the types of services that they receive. The disclosure regarding execution-only brokers would assist clients in making these determinations by providing information about the availability of brokerage alternatives, and, by implication, the effect that soft dollar services may have on commission rates.[33]

The table would be followed by certain data concerning the adviser's direction of brokerage: the percentages of the adviser's total brokerage that are directed (1) by the adviser to research brokers, (2) by the adviser to execution-only brokers, and (3) pursuant to specific client instructions.[34] This data would provide clients with an overall picture of how the adviser directs brokerage.

B. Disclosure of Brokers

As noted above, the report would be required to include information about twenty research brokers and three execution-only brokers.[35] Limiting the required disclosure to this number of brokers is intended to result in reports that provide useful information in a relatively concise manner. Comment is requested whether the proposed numerical thresholds are appropriate. Comment is also requested whether, as an alternative, disclosure should be required about brokers to which the adviser directed more than a specified percentage of its brokerage, such as one percent.

For the purposes of the amendments, a broker would be considered an ''execution-only'' broker if substantially all of the services that the broker provides to the adviser are execution services, *i.e.*, effecting securities transactions and performing functions incidental to or required in connection with effecting those transactions.[36] Consequently, a broker would not be permitted to be considered an execution-only broker if it provided any significant amount of soft dollar services to the adviser, even if the services were not solicited or used by the adviser.[37] If a broker provided only execution services to an adviser, however, the adviser would include the broker as execution-only even if the broker provided additional services, such as research, to its other customers. The definition of execution-only broker would include automated trading systems (e.g., the Instinet and Lattice systems) if the adviser received only execution and execution-related services as a result of using the system, regardless of whether the system itself is required to be registered as a broker-dealer under the 1934 Act.[38]

An adviser that did not utilize any research brokers or that did not utilize any execution-only brokers would be required to so state under the appropriate heading in the table.[39] An adviser that directed client commissions to fewer than twenty research brokers and/or fewer than three execution-only brokers would be required to disclose under the appropriate headings those brokers to which it did direct client commissions. As a result, an adviser's annual report would always include some reference to the existence of execution-only brokers. Comment is requested whether there are better ways to disclose to clients the availability and cost of brokerage alternatives. For instance, comment is requested whether an adviser should be required to disclose execution-only brokers that offered to execute client transactions. Similarly, comment is requested whether the table should include

[29] The definition of ''brokerage discretion'' is discussed at notes 58–59 and accompanying text infra.

[30] For the purposes of the amendments, ''commissions'' would include amounts of mark-ups and mark-downs on principal transactions if those amounts are included on the confirmation of the transaction required under rule 10b–10 under the 1934 Act. See Section II.E infra. These mark-ups and mark-downs, however, are not commissions for purposes of Section 28(e). See note 10 supra.

[31] The definition of ''execution-only broker'' is discussed at notes 36–38 and accompanying text infra.

[32] Items 2–3 of proposed Form ADV–B. For purposes of determining the amount of commissions and the corresponding percentage of the adviser's discretionary brokerage that this amount represents, sales loads on transactions in investment company shares would be considered commissions. Because sales loads typically are not calculated on a cents per share basis and could potentially distort the average commission rate data, sales loads would not be considered in calculating average commission rates. Instruction 3 to Item 2 of proposed Form ADV–B.

[33] The Commission recognizes that the use of execution-only brokers would not be appropriate or possible in many circumstances. The proposed disclosure about execution-only brokers is not intended to imply that such brokers could have been used in all circumstances. Furthermore, an adviser would be permitted to explain its policies regarding the use of execution-only brokers in a narrative portion of the annual report. See General Instruction 6 to Proposed Form ADV–B.

[34] Item 4 of proposed Form ADV–B.

[35] For purposes of the annual report, a ''broker'' would include a bank that is not registered as a broker-dealer under the 1934 Act. Instruction 1 to Item 2 of proposed Form ADV–B.

[36] Instruction to Item 3 of proposed Form ADV–B. The definition of execution-only broker is derived from Section 28(e)(3)(C) of the 1934 Act [15 U.S.C. 78bb(e)(3)(C)]. Under that section, custody of securities is a function incidental to effecting a transaction in the securities.

[37] A broker would be permitted to be considered an execution-only broker if it provided a minimal amount of soft dollar services to the adviser, such as a single research report or a single contact with a securities analyst.

[38] Instruction to Item 3 of proposed Form ADV–B. Typically, the sponsor of an automated trading system will be required to be registered as a broker-dealer under the 1934 Act. An automated trading system would be included in the definition of broker in Form ADV–B if a fee is charged for using the system, regardless of the basis for the fee (*e.g.*, a flat usage fee or transaction-based fees).

[39] Items 2 and 3 of proposed Form ADV–B.

disclosure regarding *all* brokers used by the adviser.[40]

Comment is requested generally on the definition of an execution-only broker, and whether the proposal's classification of brokers into two types, execution-only and all others, is appropriate or practicable. Instead of classifying brokers by type, the Commission considered proposing that advisers be required to classify brokers or specific trades based upon the purposes for which the trades were directed to the broker (e.g., execution or research). Under this approach, trades directed to a broker that provided soft dollar services could be considered to be directed for the purposes of execution if the services were a minimal factor in directing the brokerage. The Commission is not proposing this approach because determining the purposes for which brokers are used or individual trades are directed may be impracticable and burdensome.[41] The proposed approach, which would not permit an adviser to treat a broker from whom it receives significant soft dollar services as an execution-only broker, seeks to reduce the burden on advisers by providing a more objective basis for classifying brokers. Nevertheless, comment is requested whether the annual report should require advisers to classify brokers or trades by the purposes for which the adviser directed the brokerage.

C. Disclosure of Products and Services Received

The annual report would describe the soft dollar services received by the adviser from each research broker listed. Except as discussed below, soft dollar services would be required to be identified specifically.[42] The producer of a third-party soft dollar service would be identified unless its name was evident from the name of the product. This information is intended to permit a client to assess whether it benefits from the soft dollar services that the adviser receives and, consequently, whether it should attempt to limit the adviser's use of its brokerage.

In many cases, an adviser receives research reports from a broker or is given access to the broker's securities professionals in exchange for the direction of brokerage. An adviser would not be required to list separately every report that it received or each professional with whom it had contact. Instead, an adviser would be permitted to refer to these services generically according to the following categories: (1) Analyses and reports on specific securities, issuers or industries, (2) political or economic analyses or reports, or (3) access to securities analysts.[43] All other services, including computer hardware, software, databases, and on-line services, financial or other publications available by subscription, and any products or services falling outside the scope of Section 28(e) of the 1934 Act, would be required to be identified specifically.

Comment is requested whether soft dollar services should be identified in this manner. Should the Commission require more specific disclosure of research reports or access to securities analysts or other professionals, or permit general descriptions of other services? Comment is requested whether, either in lieu of or in addition to separate identification of the services received, soft dollar services should be required to be classified into specified categories, and, if so, what those categories should be.[44]

In addition to requiring a description of the soft dollar services received, the Goldman/Morgan Proposal would have required that an adviser disclose the price in commission dollars and fair market value of each third-party soft dollar service (which typically will be provided at an explicit price). As noted above, the Goldman/Morgan proposal would not require this disclosure regarding proprietary soft dollar services, as these services are not explicitly assigned a price. Price and fair value information may be useful as an expression of the value of the soft dollar services obtained by the adviser.[45] The Commission is concerned, however, that unless the values of proprietary soft dollar services are also included in the report, the information provided to the client would be incomplete and may distort client understanding about the benefits that advisers receive through client brokerage. Clients, for example, may incorrectly believe that soft dollar services are not a consideration in an adviser's direction of client brokerage to full service brokers or that third-party soft dollar services are of greater value (either to advisers or clients) than proprietary soft dollar services. Moreover, the Goldman/Morgan Proposal may provide an investment adviser an incentive to direct brokerage to a full service broker rather than a soft dollar broker for the same types of soft dollar services, simply because of differing client reporting requirements. This consequence may not be in the best interests of advisory clients and may be unfair to soft dollar brokers. Thus, consistent with the staff's recommendations in the Market 2000 report, the Commission is not proposing that only third-party soft dollar services be valued.

The Commission also considered requiring advisers to report the fair market value of all soft dollar services, regardless of their source. Because there often is no agreed upon price for proprietary soft dollar services, their fair market value may not readily be ascertainable. One approach might be to require advisers to disclose the cost to the broker of producing proprietary soft dollar services. The cost of producing services, however, may not reflect their fair market value, and an adviser may not be able to verify cost information provided by brokers.[46] Alternatively, the value of soft dollar services to the adviser receiving them could be

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[40] In order to keep the report at a manageable length, an adviser could be permitted merely to indicate whether or not it received soft dollar services, rather than to identify the services received, from brokers that were not among those it used most frequently (e.g., the top twenty).

[41] In 1976, the Commission proposed rule 28e2–1 under the 1934 Act, which would have required advisers to make certain disclosures to clients concerning soft dollar practices in a separate annual report. Securities Exchange Act Rel. No. 13024 (Nov. 30, 1976) (41 FR 53356 (Dec. 6, 1976)). The proposed rule, which was not adopted, would have required, among other things, narrative disclosure concerning research received ''in return for'' brokerage. Commenters stated that it was impracticable to determine whether research was obtained ''in return for'' specific services, particularly when the research was not solicited. *See* Securities Exchange Act Rel. No. 10569 (Jan. 30, 1979) (44 FR 7864 (Feb. 7, 1979)) (''Release 10569'').

[42] Instruction 7 to Item 2 of proposed Form ADV–B.

[43] *Id.*

[44] In connection with its annual survey of institutions regarding their brokerage practices, *see* note 2 and accompanying text *supra*, Greenwich Associates uses the following nine categories of soft dollar services: performance measurement, third-party research, corporate fundamental databases, technical analysis software, portfolio modeling and strategy software, on-line stock price quotations, specialized political or economic analyses, terminals and computers, and custody services. Greenwich Associates, Institutional Equity Investors 1994 (statistical supp.) 19.

[45] The Commission recently proposed that estimates of the value of non-monetary payments for order flow be disclosed to customers of brokers receiving such payments. Securities Exchange Act Rel. No. 34903 (Oct. 27, 1994) (59 FR 55014 (Nov. 2, 1994)). Payment for order flow is payment by a broker, dealer, securities exchange, securities association or exchange member to a broker or dealer in return for the routing of customer orders to the broker, dealer, securities exchange, securities association, or exchange member.

[46] In addition, it is unclear how a broker's ''cost'' should be determined. An ''average cost'' could be obtained by dividing the cost of producing the services by the number of recipients. ''Marginal cost'' would measure the actual cost of providing the research to the last adviser. Full service brokers frequently distribute to advisers and other customers research services that were initially produced for other purposes. The marginal cost of such research might be only the cost of its distribution.

required to be disclosed, but it may be inappropriate and misleading to reflect services that the adviser did not solicit or use as having no value.[47]

An adviser could be required to make a good faith estimate of what the proprietary soft dollar services would have cost in an arms-length transaction.[48] This approach would require advisers to report positive values for unsolicited and unused services, which could lead investors to believe that the adviser (or the client) substantially benefited from the direction of the brokerage when, in fact, receipt of the services was incidental to brokerage direction decisions made wholly on the basis of the broker's execution capabilities. In addition, good faith estimates may be very difficult to make if the services provided are unlike those available for hard dollars. In this regard, the Commission is concerned with the burden that a good faith estimate requirement would impose on advisers and brokers and the accuracy of the information that would be reported to clients.[49]

The disclosure that the Commission is proposing to require is designed to alert a client that the adviser receives soft dollar services from directing client commissions, and provide some indication of the extent to which the client benefits from that direction. The commission rate information, including the commission rates of execution-only brokers, may provide valuable information on the costs of soft dollar arrangements and may render valuation estimates unnecessary. If additional information is desired, the client can request it from the adviser.

Comment is requested whether the commission price and fair market value of particular soft dollar services, or the soft dollar services obtained from a broker in the aggregate, should be required in the annual report. Commenters favoring inclusion of this information should discuss how the price and value of proprietary soft dollar services should be determined.

D. Client-Directed Brokerage

Many clients of investment advisers instruct their advisers to direct some or all of their transactions to a particular broker or brokers. A client may direct its brokerage, among other reasons, to obtain services for its own benefit or because of a pre-existing relationship with the broker.

In addition to disclosing the percentages of an adviser's total commissions that are directed to execution-only and research brokers, the proposed annual report would be required to disclose the percentage of commissions that is directed by clients.[50] Client restrictions on an adviser's brokerage discretion may be of interest to other clients of the adviser because they may cause a larger proportion of the brokerage of the other clients to be used to obtain soft dollar services for the adviser. Information on client-directed brokerage, therefore, may be useful to clients in determining the amount of brokerage available to the adviser to purchase soft dollar services. Comment is requested whether the proposed disclosure of the percentage of client-directed brokerage would be useful, and whether the Commission should require that the data be accompanied by disclosure explaining its usefulness.

E. Principal Transactions

Proposed Form ADV–B would require an adviser to include in the commission and commission rate in the table mark-ups and mark-downs paid in connection with principal transactions if the amounts of these mark-ups or mark-downs are included in the confirmations of the transactions required under rule 10b–10 under the 1934 Act. Rule 10b–10 requires that a dealer include transaction cost data in confirmations of (1) riskless principal transactions in equity securities if the dealer is not a market maker in the securities, and (2) transactions in a listed equity securities and certain Nasdaq securities.[51]

Proposed Form ADV–B would not require disclosure of information about other principal transactions or the mark-ups, mark-downs or spreads paid on these transactions. It may be difficult to accurately determine transaction costs associated with these principal transactions. Furthermore, disclosure about adviser direction of principal transactions may not be necessary, as soft dollar arrangements involving principal transactions may be less common than those involving agency transactions because principal transactions are not afforded the safe harbor provided by Section 28(e).[52]

Comment is requested whether the annual report should include information on all principal transactions, and, if so, how the associated costs should be determined. Comment is also requested whether disclosure requirements that apply primarily to agency transactions would cause more transactions to be executed on a principal basis.

The proposal would require disclosure of the brokers to which the greatest amounts of commissions had been directed. Alternatively, the obligation to disclose information about a broker could be based on the dollar amount of transactions, both principal and agency, directed to the broker. The resulting disclosure might be more useful to clients in assessing any relationship that may exist between the adviser's use of principal transactions and its receipt of soft dollar services. Comment is requested whether the basis for requiring a broker to be listed in the annual report should be the dollar amount of transactions directed to the broker, rather than the amount of commissions.

F. Client-Specific Information

The proposed amendments would not require that an adviser provide each client with information about how that

[47] An adviser could be required to report only those proprietary soft dollar services for which it specifically directed brokerage. Such a limitation, however, would require highly subjective determinations by advisers, and, as a practical matter, might elicit disclosure about only third-party soft dollar services.

[48] This approach was suggested by one commenter on the Commission's recent proposal to require that mutual fund expenses paid by brokers should be included in fund expense and performance data. *See* Investors Research Letter, *supra* note 25. In that proposal, the Commission requested comment whether the value of research services received by a fund's adviser should also be included in fund expenses, and how the research should be valued. *See* Investment Company Act Rel. No. 20472 (Aug. 11, 1994) (59 FR 42187 (Aug. 17, 1994)), at § II.A.1. Most commenters on the proposal, however, opposed the inclusion of research services in fund expenses, and those commenters that favored it generally provided little guidance regarding how to value proprietary services.

[49] In proposing rule 28e2–1, the Commission proposed that the fair value of non-research services be disclosed, and requested comment on the feasibility and desirability of requiring disclosure of specific dollar amounts of brokerage commissions paid to receive research services. Commenters asserted that it would be impracticable to value soft dollar services or to separate commissions into their research and execution components. *See* Release 10569, *supra* note 41.

[50] Item 4 of proposed Form ADV–B.

[51] Paragraph (a)(8) of rule 10b–10 [17 CFR 10b–10(a)(8)].

[52] The safe harbor does not encompass soft dollar arrangements under which research services are acquired as a result of principal transactions. *See* note 10 *supra*. Notwithstanding the lack of availability of the safe harbor, the Commission understands that full service brokers sometimes provide research and other services based, at least in part, on principal transactions. If an adviser were required to list a broker in its annual report because the broker is used frequently for agency transactions, the adviser would be required to take all of the soft dollar services obtained from the broker into account in responding to the report's requirement to list the services obtained, even if some of the services could be deemed to be received as a result of principal transactions not within the scope of the proposed amendments. Instruction 7 to Item 2 of proposed Form ADV–B.

client's brokerage was directed (''client-specific information''). Client-specific information could assist a client in comparing the use of its brokerage with that of the adviser's other clients.[53] The benefits of a requirement to disclose client-specific information, however, may be outweighed by the time and cost to advisers of preparing separate reports for every client. This cost would likely be passed on to advisory clients. Furthermore, advisory clients currently receive or have access to confirmations of their transactions that disclose the identities of the brokers used and the amounts of commissions charged.[54] Comment is requested whether client-specific information should be required in the annual report and, if so, what information should be required.[55]

G. Delivery and Filing

Reports on Form ADV–B would be prepared on an annual basis and would report on brokerage directed during the adviser's most recently completed fiscal year.[56] The report would be required to be filed with the Commission and delivered to clients no later than sixty days after the end of the fiscal year, and delivered to prospective clients no later than the time that an advisory contract is entered into.[57]

Because the report would provide information about brokerage over which the adviser has discretion, the report would be required to be delivered only to those clients over whose accounts the adviser has or will have brokerage discretion. An adviser would be considered to have brokerage discretion over an account if it (1) had the authority to determine, without obtaining specific client consent, the brokers to be used or the commissions paid in connection with any transactions for the account, or (2) significantly influenced the selection of brokers by a client and received soft dollar services from a broker chosen by the client.[58] An adviser would not be required to provide the report to a client that, without the adviser's influence, directed that a single broker execute its transactions, or prior to each transaction approved the broker to be used for the transaction.[59] Comment is requested whether this definition of brokerage discretion is appropriate, and whether the report should be required to be delivered to clients over whose accounts the adviser does not have brokerage discretion.

The Commission is proposing that the report be prepared on an *annual* basis. More frequent reporting would be more costly and may not be necessary for clients to monitor an adviser's brokerage direction practices. Furthermore, an annual report may provide a more representative sample of an adviser's brokerage practices. Comment is requested whether the report should be required to be prepared more frequently than annually, such as quarterly.[60]

H. Goldman/Morgan Proposal

The Goldman/Morgan Proposal differs from the Commission's proposal in a number of respects. The Goldman/Morgan Proposal would, among other things, require quarterly rather than annual reporting, require disclosure of the commission price and value of specific third-party soft dollar services, and require disclosure of certain client-specific information. The Commission has requested comment on these elements of the Goldman/Morgan Proposal separately in this Release. The Commission also requests comment whether the Goldman/Morgan Proposal generally would be preferable to the Commission's proposal.

III. Disclosure By Brokers Providing Soft Dollar Services

The amendments being proposed in this Release would require disclosure by *advisers* that receive soft dollar services from brokers. In a letter to the staff, Autranet, Inc. (''Autranet''), a broker providing third-party soft dollar services to advisers, proposed an entirely different approach that would impose certain recordkeeping and disclosure requirements on *brokers* providing third-party soft dollar services to ensure that the services were provided within the safe harbor of Section 28(e) of the Exchange Act.[61] Under the Autranet

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[53] To the extent differences between the manner in which an adviser uses a particular client's brokerage and the brokerage of the adviser's other clients is caused by client-directed brokerage, the requirement of the proposal to disclose the percentage of client-directed brokerage might render client-specific information unnecessary. *See* Section II.D *supra.*

[54] *See* rule 10b–10 under the 1934 Act [17 CFR 240.10b–10] (requiring broker-dealers to send immediate confirmations of transactions to their customers). The confirmations, or quarterly statements containing all of the information required in the confirmations, must be sent to the holder of the account, rather than any fiduciary managing the account. *See* Securities Exchange Act Rel. No. 34962 (Nov. 10, 1994) [59 FR 59612 (Nov. 17, 1994)] at § II.A.2.

[55] As noted above, an adviser to an investment company is required to provide information about its soft dollar arrangements to the company's board of directors. *See* note 24 *supra.* The information provided by the adviser generally should include specific information about the adviser's use of the investment company's brokerage. The proposed annual report would supplement this fund-specific information.

[56] Paragraph (a) of proposed rule 204–4; General Instructions 1 and 5 to proposed Form ADV–B. The table in the annual report would be required to disclose commissions paid during the adviser's most recently completed fiscal year even if soft dollar services paid for with those commissions had been or will be received during another fiscal year. Conversely, disclosure of soft dollar services received during a fiscal year would be required even if commissions were or will be directed to pay for those services during another fiscal year. General Instruction 5 to proposed Form ADV–B.

[57] Paragraphs (a) and (b) of proposed rule 204–4; General Instructions 3 and 4 to proposed Form ADV–B. Rule 204–3 under the Advisers Act, which generally requires advisers to furnish a disclosure brochure to prospective clients no later than 48 hours prior to the time that the advisory contract is entered into, permits the brochure to be delivered at the time that the contract is entered into if the contract can be terminated without penalty within five business days. Paragraph (b)(1) of rule 204–3 [17 CFR 275.204–3(b)(1)]. Proposed rule 204–4 would not similarly differentiate between providing the annual report before or at the time that the contract is entered into. Generally, however, the determination of when a contract is entered into would be the same for the purposes of both rules.

[58] Paragraph (c)(1) of proposed rule 204–4; General Instruction 2 to proposed Form ADV–B. An adviser would not be deemed to have brokerage discretion over an account if substantially all of the client's transactions were directed to a broker that was compensated for executing the transactions based upon a percentage of the assets managed by the adviser, such as in a ''wrap fee'' program, even if the adviser could in certain circumstances direct the client's transactions to other brokers.

[59] An adviser would be required to deliver the annual report to a client if the adviser had discretion over any of the client's brokerage, even if some or most of the client's brokerage was directed by the client. Delivery of the annual report also would be required if the adviser had the authority to select brokers for particular transactions from a list previously approved by the client.

[60] The Morgan/Goldman Proposal would have required quarterly reporting.

[61] Autranet also has proposed that the Commission prohibit understandings that commit an adviser to a predetermined amount of commissions in exchange for soft dollar services. The Commission requests comment on the feasibility of this proposal. In particular, the Commission requests comment whether prohibiting a stated commission ratio in exchange for soft dollar services will deter the negotiation of commission rates and cause advisers that are less sophisticated or influential to pay higher commissions.

In addition, Autranet proposed that the Commission ensure that an independent research originator make its services available to a number of brokers and not enter into exclusive agreements. For instance, under ''bump up'' or bonus arrangements a vendor will assign a cash value to its product and offer it to the public at large for a lower price than charged to a broker providing the product pursuant to a soft dollar arrangement. In other arrangements, a vendor will tie the availability of its product to a single affiliated or unaffiliated broker, thus causing all trades to go through that broker in exchange for the service. Autranet believes that by eliminating commission commitments and exclusivity arrangements, a client can be better assured that the adviser obtained the best execution of the client's order. The Commission requests comment on the feasibility of a prohibition on exclusivity and bonus arrangements and whether such a proposal would accomplish the objective of assuring best execution. The Commission also has forwarded these proposals to the NASD for its consideration under its authority to promulgate just and equitable principles of trade.

proposal, these brokers would be required to demonstrate that they incurred a legal obligation to provide soft dollar services to an adviser. This obligation could be demonstrated either by a contract that indicates the broker's financial obligation to purchase the soft dollar services from an independent research originator, or by an invoice showing the broker's payment for the services for those soft dollar services not typically the subject of a contract.

In addition, Autranet proposes that third-party soft dollar brokers be required to provide a description of the soft dollar services provided in an arrangement and specify how the product assists an adviser in its investment decisions. A broker would be required to make this description available to the managed account upon request and provide the managed account a quarterly report showing the cost of the soft dollar service. For products having a mixed-use, Autranet proposes that the broker providing such a product obtain from the adviser a description of the adviser's use of the product and the adviser's allocation between the research and non-research functions of the product.

Autranet proposes that these descriptions be reflected in an annual report that third-party soft dollar brokers would file with the Commission and provide to the advisers receiving soft dollar services and to the clients of those advisers whose commissions were used to obtain the soft dollar services. Autranet proposes that the report include (1) a disclosure statement describing the business of the third party broker; (2) a financial summary, quantifying on an aggregate basis the value by category and, if necessary, sub-category, of the soft dollar services provided; (3) a compliance report, demonstrating that the soft dollar services were in compliance with the requirements set forth above and within the safe harbor of Section 28(e); and (4) an independent auditor's report. Autranet believes that such a reporting requirement would not be costly to third-party brokers because the information required is readily available and the reporting requirements should reflect compliance procedures already established by third-party brokers providing soft dollar services.

The Commission requests comment on whether some or all of the Autranet proposals would be practical additions to the disclosure currently required and proposed of advisers. In particular, the Commission requests comment on the costs associated with this disclosure approach and the ease with which this information could be obtained by brokers and provided to advisers and their clients. In addition, the Commission requests comment on the extent to which full service brokers providing proprietary soft dollar services could or should be subject to any of the reporting requirements proposed by Autranet.

IV. General Request For Comments

Any interested persons wishing to submit written comments on the proposals that are the subject of this Release, to suggest additional changes, or to submit comments on other matters that might have an effect on the proposals that are contained in this Release, are requested to do so.

V. Cost/Benefit Analysis

The rule and form proposed today are intended to provide material information to clients and prospective clients of investment advisers that can be used to evaluate an adviser's brokerage direction and soft dollar practices. The proposals would enable an advisory client to better assess whether its adviser is directing its brokerage in accordance with its best interests, and whether the advisory fee it pays is appropriate in light of the services provided and costs incurred directly by the adviser.

Adoption of the proposal would impose some additional costs on advisers required to prepare the report and deliver it to clients. The Commission believes, however, that the proposals appropriately balance the need for additional disclosure with the costs of providing that disclosure. The information that would be required by the proposal should readily be determinable by an adviser. A number of alternatives that would make the disclosure requirements more burdensome, such as requiring advisers to disclose the value of soft dollar services received or report on the use of each client's brokerage, are not being proposed. Furthermore, because the report would need to be prepared and delivered only annually, the costs of preparing and delivering the report should be minimized. In short, the Commission believes that the costs of the proposals would be outweighed by the benefits to advisory clients in receiving more useful information about their advisers' direction of client brokerage.

VI. Summary Of Initial Regulatory Flexibility Analysis

The Commission has prepared an Initial Regulatory Flexibility Analysis in accordance with 5 U.S.C. 603 regarding the proposed amendments. The analysis notes that the rule and form proposed in this Release are intended to provide investment advisory clients for whom the adviser selects brokers to execute client transactions with information about the services the adviser receives from those brokers and the commissions charged by those brokers. Other aggregate cost-benefit information reflected in the ''Cost/Benefit Analysis'' section of this Release also is reflected in the analysis. A copy of the Initial Regulatory Flexibility Analysis may be obtained by contacting Jana M. Cayne, Securities and Exchange Commission, 450 Fifth Street, NW., Mail Stop 10–6, Washington, DC 20549.

VII. Statutory Authority

The Commission is proposing rule 204–4 and Form ADV–B under the authority set forth in Sections 204, 206(4) and 211(a) of the Advisers Act [15 U.S.C. 80b–4, 80b–6(4) and 80b–11(a)] and Section 28(e)(2) of the 1934 Act [15 U.S.C. 78bb(e)(2)].

Text Of Proposed Rule And Form Amendments

List of Subjects in 17 CFR Parts 275 and 279

Investment advisers, Reporting and recordkeeping requirements.

For the reasons set out in the preamble, title 17, chapter II of the Code of Federal Regulations is proposed to be amended as follows.

PART 275—RULES AND REGULATIONS, INVESTMENT ADVISERS ACT OF 1940

1. The authority citation for Part 275 is amended by adding the following citation:

Authority: 15 U.S.C. 80b–3, 80b–4, 80b–6A, 80b–11, unless otherwise noted.

* * * * *

Section 275.204–4 is also issued under 15 U.S.C. 78bb(e)(2).

2. By adding § 275.204–4 to read as follows:

§ 275.204–4 Annual report on brokerage practices.

(a) Each investment adviser, registered or required to be registered under Section 203 of the Act on the last day of its most recently completed fiscal year, that exercised brokerage discretion over the account of any client during that fiscal year *and* obtained services other than execution services from a broker to which it directed client brokerage during that fiscal year shall file a report on Form ADV–B with the Commission no later than 60 days after the end of that fiscal year, unless the investment adviser's registration was

withdrawn, cancelled or revoked after the end of the fiscal year.

(b) An investment adviser required to file a report on Form ADV–B pursuant to paragraph (a) of this section shall furnish such report for its most recently completed fiscal year:

(1) No later than 60 days after the end of each fiscal year, to each advisory client over whose account the investment adviser exercises brokerage discretion; and

(2) No later than the time that a written or oral investment advisory contract is entered into, to each new or prospective advisory client over whose account the investment adviser will or proposes to exercise brokerage discretion.

(c) For purposes of this section:

(1)(i) An investment adviser exercises ''brokerage discretion'' over a client's account if it:

(A) Has authority to determine, without obtaining specific client consent, the broker to be used or the commission rates paid in connection with any transaction of the client; or

(B) Significantly influences the selection of brokers by the client and receives services other than execution services from a broker chosen by the client.

(ii) An investment adviser does not exercise brokerage discretion over a client's account if substantially all of the client's transactions were directed to a broker that was compensated for executing such transactions solely based upon a specified percentage of the assets managed by the investment adviser; and

(2) Execution services mean those services set forth in paragraph (e)(3)(C) of Section 28 of the Securities Exchange Act of 1934 (15 U.S.C. 78bb(e)(3)(C)).

PART 279—FORMS PRESCRIBED UNDER THE INVESTMENT ADVISERS ACT OF 1940

3. The authority citation for Part 279 is amended by adding the following citation:

Authority: The Investment Advisers Act of 1940, 15 U.S.C. 80b–1, *et seq.*

Section 275.204–4 is also issued under 15 U.S.C. 78bb(e)(2).

4. By adding § 279.9 and Form ADV–B to read as follows:

§ 279.9 Form ADV–B, annual report on investment adviser's brokerage direction practices.

This form shall be filed annually by an investment adviser, registered or required to be registered under the Investment Advisers Act of 1940, that has the authority to select brokers to execute the transactions of any client and that obtains services other than execution from a broker to which it directs client brokerage.

Note: Form ADV–B is attached as Appendix 1 to this document. The Form will not appear in the Code of Federal Regulations.

Dated: February 14, 1995.

By the Commission.

Margaret H. McFarland,

Deputy Secretary.

Appendix 1

OMB Approval
OMB Number:
Expires:
Estimated average burden hours per response:
U.S. Securities and Exchange Commission, Washington, DC 20549

Form ADV–B

Annual Report on Brokerage Practices for Registered Investment Advisers Having Discretion Over Client Brokerage

Applicant: _____

SEC File Number: 801– _____

Date: _____

MM/DD/YY

General Instructions for Preparing and Filing Form ADV–B

1. Applicability of Form Requirement. A report on Form ADV–B must be prepared and filed by every investment adviser that (i) was registered or required to be registered under the Investment Advisers Act of 1940 on the last day of its most recently completed fiscal year (unless the adviser's registration has since been withdrawn, cancelled or revoked), (ii) exercised ''brokerage discretion'' over the account of any advisory client during that fiscal year, and (iii) obtained services other than ''execution services'' from a broker to which it directed client brokerage during that fiscal year.

2. Definitions.

Brokerage Discretion. An investment adviser exercises brokerage discretion over a client's account if it (i) has the authority to determine, without obtaining specific client consent, the broker to be used or the commission rates paid in connection with any transaction of the client, or (ii) significantly influences the selection of brokers by the client and receives services other than execution services from a broker chosen by the client. An investment adviser does not have discretion over a client's account, however, if substantially all of the client's transactions were directed to a broker that was compensated for executing such transactions solely based upon a specified percentage of the assets managed by the adviser, even if the adviser has the discretion to direct certain of the client's transactions to other brokers.

Execution Services. Execution services mean those services described in Section 28(e)(2)(C) of the Securities Exchange Act of 1934, *i.e.*, effecting securities transactions and performing functions incidental thereto or required in connection therewith by rules of the Securities and Exchange Commission or a self-regulatory organization.

3. Format and Filing of Report. The report required by this form should be prepared as a separate document, not on copies of this Form. The report shall be filed in triplicate with the Securities and Exchange Commission, 450 Fifth Street NW., Washington, DC 20549. Each copy of the report filed with the Commission should be attached to a completed copy of this page, although only one such copy need be manually executed. The report shall be filed no later than 60 days after the end of the adviser's fiscal year.

Execution: The undersigned represents that he or she has executed this form on behalf of, and with the authority of, said investment adviser. The undersigned and the investment adviser represent that the information and statements contained herein, including exhibits attached hereto and other information filed herewith, all of which are made a part hereof, are current, true, and complete.

Dated the _____ day of _____, 19_____

_____
(Name of registrant)

By: _____
(Signature and title)

4. Delivery.

Existing Clients. Rule 204–4 under the Investment Advisers Act of 1940 requires that the report be furnished no later than 60 days after the end of the investment adviser's most recently completed fiscal year to each advisory client over whose account the adviser exercises brokerage discretion (as defined in Instruction 2 above).

Prospective Clients. Rule 204–4 also requires that the report be furnished no later than the time that a written or oral investment advisory contract is entered into to each new or prospective advisory client over whose account the adviser will or proposes to exercise brokerage discretion.

5. Period of Required Data. An investment adviser must provide the requested information for its most recently completed fiscal year. Brokerage commissions directed or services received during a fiscal year should be included in the table, even if the services corresponding to commissions directed during the fiscal year were or will be received during another fiscal year, or the commissions corresponding to services received during the fiscal year were or will be directed during another fiscal year.

6. Additional Information. An investment adviser may, in addition to providing the required information, provide other information, including additional data and explanations of the required information, about its brokerage practices in its response to this Form.

Information Required in Annual Report

Item 1. General Description of Report

In an introduction to the report:

(a) explain that the report contains information about the adviser's practices in selecting brokers to execute transactions for its investment advisory clients that can be used to evaluate whether the adviser directs

client transactions consistent with the best interests of its clients;

(b) explain that the information contained in the report is provided on a firm-wide basis, that the report does not include specific information about the brokerage of any particular client or the extent to which services obtained are used for the benefit of any particular client, and that clients should refer to the confirmations or quarterly account statements provided by their brokers or contact the adviser for information about the brokers used to execute their transactions;

(c) explain, if applicable, that the report does not include information about many transactions executed on a ''principal'' basis, that, in principal transactions, transaction costs typically are included in the price of the securities purchased or sold and are not charged as separate commissions, and that transactions in certain types of securities typically are executed on a principal basis; and

(d) provide an address or phone number at which a client can contact the adviser to request more information.

Item 2. Information Regarding the Twenty Most Frequently Used Brokers

Using the captions and tabular format illustrated below, provide the required information for the twenty brokers (other than ''execution-only'' brokers as defined in Item 3) to which the investment adviser directed the greatest amount of client commissions. If no or fewer than twenty such brokers were used, state either ''no brokers used that provided services other than execution'' after the title or ''no additional brokers used'' after the last broker listed.

THE TWENTY BROKERS TO WHICH THE GREATEST AMOUNTS OF CLIENT COMMISSIONS WERE DIRECTED

Name of broker	Aggregate amount of discretionary commissions paid to broker (in dollars)	Commissions paid to broker (as a percentage of adviser's discretionary commissions)	Average commission rate (in cents/share)	Description of services obtained (other than execution services)

Instructions

1. For the purposes of this Form, brokers include broker-dealers registered under the Securities Exchange Act of 1934, banks, and, as set forth in Item 3, automated trading systems.

2. ''Discretionary commissions'' are those commissions, mark-ups and mark-downs that are disclosed on the transaction confirmations required under rule 10b-10 under the Securities Exchange Act of 1934 and that are paid in connection with transactions for which the investment adviser had the authority to determine, without obtaining specific client consent, the broker or dealer to be used or the commission rates paid.

3. Commissions include sales loads paid in connection with transactions in investment company shares, although sales loads should not be considered in calculating the average commission rate. If the adviser directed transactions in investment company shares to a broker other than the principal underwriter of the investment company, that broker, rather than the principal underwriter, should be considered to have executed the transaction.

4. For purposes of this Form, commissions do not include fees for brokerage services that are based upon a specified percentage of the assets managed (*i.e.,* fees paid under ''wrap fee'' programs).

5. Calculate average commission rates on a ''share-weighted'' basis (*i.e.,* by dividing the total amount of client commissions that the investment adviser directed to the broker by the total number of shares, exclusive of investment company shares, purchased or sold by the broker for the adviser's clients).

6. For the purposes of determining commission amounts and average commission rates, convert any commission charged in foreign currency to dollars (and cents per share). The investment adviser may use any reasonable means and times for determining the applicable exchange rate as long as those means and times are used on a consistent basis.

7. Under ''Description of Services Obtained,'' products or services obtained by the investment adviser from each broker, including computer hardware, software, databases, and on-line services, publications available by subscription, and services falling outside the scope of Section 28(e) of the Securities Exchange Act of 1934, generally should be identified separately and specifically. Research reports and contacts with securities analysts or professionals, however, may be described generally by the following terms: (i) analyses and reports on specific securities, issuers, or industries, (ii) general political or economic analyses or reports, or (iii) contacts with securities analysts. The party that produced a specifically identified product or service should also be identified unless the producer's name is evident from the name of the product or service. An adviser should report all products or services received from a broker, even if some of the services could be deemed to have been received as a result of principal transactions the costs of which are not required to be reported in the table.

Item 3. Information Regarding Three Most Frequently Used Execution-Only Brokers

Using the captions specified under Item 2 (except ''Description of Services Obtained''), provide a table titled ''The Three Execution-only Brokers to which the Greatest Amounts of Client Commissions were Directed'' that includes the required information for the three execution-only brokers to which the investment adviser directed the greatest amount of client commissions. If no or fewer than three execution-only brokers were used, state either ''no execution-only brokers used'' after the title or ''no additional execution-only brokers used'' after the last broker listed.

Instruction

For the purposes of this Item, a broker should be considered an execution-only broker if substantially all of the services that it provides to the adviser are execution services (see the definition in Instruction 2 of the General Instructions). An automated trading system should be considered an execution-only broker if substantially all of the services received by the adviser in connection with using the system are execution services and if a fee is charged for using the system, regardless of the basis for the fee (*e.g.,* a flat usage fee or transaction-based charges).

Item 4. Information Regarding Brokerage Business Directed by Clients

Provide the following information under the following captions:

Percentage of Total Commissions Directed to Brokers Providing Research and Other Services in Addition to Execution:

Percentage of Total Commissions Directed to Execution-only Brokers:

Percentage of Total Commissions Directed by Clients:

Instruction

For the purposes of this Item, commissions directed by clients are those commissions paid by accounts managed by the adviser that were directed pursuant to client requests or instructions. Total commissions equal the sum of the adviser's discretionary commissions, as defined in Item 2, and the commissions directed by clients.

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